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FROM USOECD PARIS

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FRANKFURT FOR TREASURY ATTACHE

TREASURY FOR IA -- LESLIE HULL

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SUBJECT: OECD SURVEY OF SPAIN'S ECONOMY: EROSION OF COMPETITIVENESS UNDERMINING CONVERGENCE GOAL

CONTAINS REPORT OF OECD MEETING -- NOT FOR INTERNET DISTRIBUTION

SUMMARY AND INTRODUCTION

1. The Economic and Development Review Committee of the OECD conducted an economic review of Spain on January 31, 2005. The last such review was held in February 2003. Mr. Angel Torres, Director General at the Ministry of Economy and Finance and Spain's previous EDRC delegate, led the Spanish delegation of 18. Japan and Austria were the lead examining countries. The draft survey notes that Spain's economy has been performing well but the government needs to accelerate structural reforms in order to reduce inflation, boost productivity and increase employment. Embassy Madrid has had an opportunity to see this telegram in draft. End summary.

LIGHT AND DARK

2. The draft survey notes that Spain's recent economic growth has been higher than the euro area average, although the country lags high performers in the OECD such as the United States, Australia and the Scandinavian area. Spain's persistent inflation is a problem that could be helped by eliminating structural rigidities in the housing market and a reform of the wage bargaining system.

3. Mr. Torres declared the draft survey a very good report which shed a lot of light on Spain's problems in the area of employment and productivity but, he said, "where there is light, there is also shadow". He said that the Spanish government was more optimistic than the OECD for the year 2005, noting that investment in equipment spending was recovering and that there had been a restoration of export growth in the fourth quarter of 2004.

4. The inflation differential with the euro area average is a major challenge, he said, but he criticized the OECD for minimizing the role of demand pressures in continuing inflation. He said he thought the OECD overemphasized the negative aspects of temporary employment contracts and minimized the positive. He noted that many of the OECD recommendations to reform the wage bargaining system were not feasible and that the report was too optimistic about the trade-off between productivity and employment.

THE VIEW FROM JAPAN, AND ELSEWHERE

5. The Japanese delegate, who traveled from Tokyo, noted that his country's wage bargaining system had been weakened in recent years: the fact that it continues strong in Spain is an indicator of weak competition. He said duality in the labor market existed in Japan as well, with full-time workers protected by high wages, generous benefits and employment protection legislation while part-time or temporary workers earned little and enjoyed no social safety net, but said that employment protection legislation in large companies in Japan was on the decline. Austria noted that another reason for the continuing inflation differential in Spain was a lack of competition in the retail industry.

6. The German delegate, who traveled from Berlin, criticized the Spanish authorities for not working harder to bring their inflation rate more in line with the euro area average, and worried that a collapse of the housing bubble in Spain might cause problems for the euro. The Belgian delegate, on the other hand, agreed with Spain that doing away with wage indexation it is not feasible and added that

"it may not even make economic sense". He, and a number of others, agreed that temporary contracts had a more positive aspect than the OECD gave Spain credit for. The Australian delegate argued against collective wage bargaining in the sense that it de-links wage increases from sector or company-specific productivity gains.

THE SECRETARIAT'S LAST WORD

17. Secretariat staff remarked that the Spanish output gap was bigger than the euro area average, which is an indication that the inflation differential is not demand-driven. In any case, euro membership precludes using monetary policy, so the Spanish government should adopt a more restrictive fiscal policy if it thinks demand is the source of inflation; rather, the OECD is arguing for structural reform.

18. Secretariat staff also made it clear that in negotiations over the February 2003 draft survey it had allowed itself to be persuaded by the Spanish authorities that the inflation differential was a temporary phenomenon caused by entering the euro area with an undervalued currency and because of productivity differentials between the tradable and non-tradable sectors -- the experience of persistent inflation for the past two years has proven this assertion false.

PENSIONS AND DECENTRALIZATION

19. The afternoon session was devoted to reforming the pension system and to public sector decentralization in Spain. The draft survey made the OECD standard recommendation to refrain if possible from offering tax incentives for pension saving, since this has been shown in other OECD countries to shift savings from one vehicle to another but not to increase net savings. The Spanish delegation argued that tax exemption may cause people to increase long-term savings, and since the only other long-term saving investment for most people was housing, this might serve to help cool off the housing market.

110. On public sector decentralization, the OECD recommendations that the national government improve financial arrangements for sub-national governments and develop systems to make public spending more effective were by and large accepted, albeit with resignation. Mrs. Silvia Lopez, a Director General in the Ministry of Economy and Finance, said pointedly: "Where there is a solution, there is always a problem. Where there is no solution, there is not a problem -- there is a fact. In decentralization, the government of Spain is faced with a fact."

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